United States Senate
Republican Policy Committee
Jon Kyl, Chairman
Lawrence Willcox, Staff Director
347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

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Health Savings Accounts: Defying Critics' Dire Expectations

Executive Summary

- As the Senate attempts to move to legislation designed to reduce the dramatically increasing cost of quality health care, advocates would do well to remember that one Republican-backed innovation – health savings accounts – is already proving its worth in the marketplace.
- In 2003, Congress created health savings accounts (HSAs) as a means of curbing rising health care costs. HSAs are personal and portable accounts that afford individuals the opportunity to set aside pre-tax dollars as savings toward medical and long-term care expenses not covered by their insurance plans.
- Critics charged that HSAs would benefit primarily those who are young, well-off, or very healthy; however, the available data show that HSAs are being purchased by individuals with varying incomes, ages, and health statuses.
- In the two years that HSAs have been available for purchase, more than 3.2 million individuals have signed on.
- Data reveal that nearly one-third of these participants were previously uninsured.
- Studies show that many are not young: one major individual and small-group insurer has reported that 62 percent of its HSA-eligible plan purchasers were over the age of 40, while another insurer's web-based survey indicated that the largest group of HSA purchasers were in the 45 to 54 age range.
- Many are not well-off: nearly 45 percent of HSA purchasers from one online health insurance broker earned less that $50,000 per year. Another insurer reported that 20 percent of its HSA purchasers earned less than $40,000 per year.
- Many are not in excellent health: a survey conducted in 2005 reveals that nearly as many HSA purchasers rated their health condition to be merely "fair" as did those who rated their health as "excellent."
- HSA participants are discovering what proponents have long asserted – that ownership and portability of HSAs are two characteristics that set this health insurance option apart from traditional insurance plans. No longer will employers and insurance companies be in charge of making health care decisions – with an HSA, control of one's health care lies with the individual.

Introduction

Although much has been written about health savings accounts (HSAs) and how they are changing the way people view health care, too little attention has been focused on the fact that HSAs are succeeding among the very populations critics believed would benefit least. From the outset, critics charged that HSAs would benefit primarily those who are young, well-off, or very healthy. But, as it turns out, HSAs are being purchased by individuals with varying incomes, ages, and health statuses. In particular, HSAs have proven popular among individuals who previously lacked health insurance. This paper summarizes the basic structure of HSAs and reviews the most recent data about individuals who are purchasing the accounts.

Background

Since the early 1990s, health care expenditures in the United States have risen dramatically; in fewer than 15 years, the cost of providing health care in the United States more than doubled.[1] In 1990, health care costs totaled roughly $717 billion, or about 12.5 percent of the country's gross domestic product (GDP).[2] In 2004, health care expenditures reached nearly $1.9 trillion, which represented approximately 16 percent of GDP.[3] By 2014, health care expenditures are expected to comprise nearly 19 percent of GDP, "climb[ing] at a rate several times faster than either personal income or inflation."[4]

Both Congress and the Bush Administration have sought solutions to curb rising health care costs. One solution that has received considerable attention is consumer-directed health care, which seeks to reduce spending by allowing patients to participate more fully in making decisions about their own health care and health care expenditures. Although consumer-directed health care encompasses a number of approaches, including Archer medical savings accounts (MSAs) and employer-based health reimbursement arrangements (HRAs), observers most often focus on the combined use of high-deductible health plans (HDHPs) and HSAs. In most respects, high-deductible plans provide coverage similar to traditional insurance policies, with more affordable premiums due to the higher deductibles. This paper will focus on the HDHP/HSA approach.

HSAs, which first became available to consumers on January 1, 2004, are personal accounts that afford individuals the opportunity to set aside pre-tax dollars as savings toward medical and long-term care expenses not covered by their insurance plans.[5] HSAs were created as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), which President Bush signed into law on December 8, 2003.[6]

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[1]Kaiser Family Foundation chart, "National Health Expenditures and Their Share of Gross Domestic Product, 1960-2004," available at http://www.kff.org/insurance/7031/print-sec1.cfm.
[2]*Id*.
[3]*Id.*
[4]White House National Economic Council, "Reforming Health Care for the 21st Century," February 2006, pp. 1-2.
[5]National Health Policy Forum (NHPF) Background Paper, "Health Savings Accounts: The Fundamentals," April 11, 2005.
[6]Section 1201 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, Public Law

Congress created HSAs to allow health care consumers who wish to do so to exercise more control over their care.[7] The idea is to put consumers in charge of their health care decision-making to make them better, more cost-conscious consumers; on a large scale, this will lead to a reduction in overutilization of medical services by consumers (who, under the traditional system are less informed about costs and options) and will reduce overall health care expenditures.[8]

In addition, the requirement that individuals purchase high-deductible plans (which, for the most part, charge lower premiums than standard low-deductible plans) reduces the cost of obtaining health care coverage, thereby making coverage available to more people.[9]

<u>Opening a Health Savings Account</u>

In order to establish an HSA, individuals must not be Medicare or Medicaid-eligible, may not be claimed as a dependent on someone else's tax return, and must enroll in a high-deductible health plan.[10] The deductible is the amount that an individual must pay out-of-pocket toward his own medical costs before insurance coverage kicks in. In 2006, the minimum deductible requirement for HSA-eligible, high-deductible plans is $1,050 for individual coverage and $2,100 for family coverage.[11] Even though an individual will pay a greater amount of costs incurred before reaching the deductible, the law limits the amount an individual will be required to pay out-of-pocket toward his health care costs in a given year.[12] It is also important to note that the cost of obtaining preventive medical care need not be subject to the deductible.[13]

Once enrolled in a high-deductible plan, an individual can open the accompanying HSA with the insurance company, a bank, credit union, or other approved company that meets HSA

108-173, H.R. 1, 108th Congress, 1st Session, December 8, 2003 (hereafter referred to as MMA).

[7]See, for example, Senate Majority Leader William Frist, Fact Sheet, "Giving Americans More Control Over Health Care Choices & Hard Earned Dollars," March 1, 2004. "The new law [MMA] creates Health Savings Accounts (HSAs) to help American families save for current and future health care expenses, giving them more control over their health care choices and hard earned dollars."

[8]See, for example, Roberta W. Goodman, "Healthier, Wealthier and Wiser? An Overview of Consumer-Driven Health Care," Executive Summary, 2005.

[9]*Id.*

[10]Individuals may not contribute to an HSA while covered by any plan that is *not* a high-deductible plan or that provides coverage for any benefit covered by the high-deductible plan. The MMA provides exceptions for "permitted insurance," including coverage for "accidents, disability, dental care, vision care, or long-term care."

[11]Congressional Research Service (CRS), "Health Savings Accounts: Overview of Rules for 2006," January 31, 2006. The minimum deductible for future years will be adjusted for inflation and will be rounded to the nearest $50.

[12]CRS. In 2006, individuals with self-only coverage will pay no more than $5,100 of their own money for covered benefits before full coverage begins. Similarly, those covered under family plans will pay no more than $10,200 of their own money. As with the minimum required deductible, the out-of-pocket limits are adjusted each year for inflation and rounded to the nearest $50.

[13]MMA Section 1201. Although the MMA does not define what services constitute preventive care, IRS regulations provide some guidance. Examples of preventive care include periodic health evaluations (annual physicals), screening services (mammograms), routine prenatal and well-child care, immunizations, and tobacco cessation and weight loss programs. See, "All About HSAs," U.S. Treasury Department, November 28, 2005, available at http://www.treasury.gov/offices/public-affairs/hsa/pdf/hsa-basics.pdf.

criteria.[14] Account holders, their employers, and others may contribute to HSAs, up to the applicable limit. In 2006, contributions may total $2,700 or the amount of the plan deductible, whichever is lower.[15] For family coverage, contributions may total $5,450, the amount of the total plan deductible, or the amount of the deductible for an individual covered by the family plan (known as an embedded deductible), whichever is lowest.[16]

Contributions into the HSA may be made at any time between January 1 and April 15 of the following year, up to the applicable annual limit. In a given year, individuals may deduct from their income tax liability the full amount that they contribute to their HSAs, regardless of whether they itemize their deductions or claim the standard deduction.[17]

As with other personal accounts, the funds deposited in an HSA can be invested in a variety of interest-earning options, such as stocks or mutual funds, and the interest earned is not subject to taxation.[18]

Using a Health Savings Account

The Internal Revenue Service (IRS) is the agency responsible for regulating HSAs and has issued a number of documents that provide guidance about the use of HSAs. Generally, the use of HSA funds are limited to those known as "qualified medical expenses." These expenses are enumerated and explained in IRS Publication 502, and are those that generally qualify for the medical and dental expenses deduction available when filing income tax returns or for reimbursement from a flexible spending account (FSA).[19] This list is very extensive and includes expenditures ranging from over-the-counter and prescription medications to Braille books and magazines or hand controls installed in the car of a disabled individual. Qualified medical expenses include an individual's coinsurance and deductible amounts but do *not* currently include most premium payments (the cost of obtaining health insurance).[20]

Money deposited in an HSA can be used to pay medical expenses as they accrue or can be saved, accumulating tax-free interest, for future medical expenses. Some high-deductible plan sponsors have greatly simplified the ability for enrollees to access their HSA dollars by providing dedicated checkbooks or debit cards that patients can use to pay providers directly or withdraw money from the account to recoup for expenses they previously paid.[21] Account

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[14]MMA Section 1201.
[15]CRS.
[16]*Id.* The amount that an individual may contribute to his account (or have contributed on his behalf) will increase each year based on inflation and rounded to the nearest $50.
[17]CRS.
[18]NHPF. Investment options include bank accounts, annuities, certificates of deposit, stocks, mutual funds, and bonds. The major exceptions to this rule are that HSA funds may not be invested in life insurance, collectibles, real property, and certain personal property.
[19]Internal Revenue Service (IRS) Publication 502, based on Internal Revenue Code Section 213(d).
[20]*Id.* Premium payments for long-term care insurance, COBRA coverage, or Medicare coverage (except Medigap policies) are permissible qualified medical expenses.
[21]HSA dollars may not be used to pay for medical expenses incurred prior to the account being established. Consumer tools may also include benefits such as detailed websites to assist in health care decision-making (PowerPoint presentation, "Consumer-Directed Plans in Practice: Perspectives from Consumers and the Blues," BlueCross BlueShield Association, September 28, 2005.), provider quality data, self-diagnostic tools, and direct

holders receive periodic statements detailing the account balance, the amount of interest earned, and any account maintenance fees being paid out of the account.[22]

In general, amounts withdrawn from an HSA are not included in an individual's gross income.[23] However, withdrawals made for non-qualified medical expenses or used for other improper purposes are subject to a 10-percent penalty and are taxed to the individual as part of gross income.[24] The penalty and tax treatment do not apply in the case of withdrawals that are repaid to the account before the end of the tax year, or for those made after the account holder dies, becomes permanently disabled, or reaches 65 years of age.[25]

Critics Predicted HSAs Would Fail, But Experience Proves Otherwise

Critics have charged that HSAs would lead to segmentation of the health insurance market. Primarily younger patients and healthier patients, they said, would gravitate toward HSAs, skewing the insurance risk pools, and thus increasing health insurance costs for those left in the higher-risk pools.[26] This, in turn, would lead to higher numbers of uninsured, as the higher costs would force some consumers to drop coverage. They also suggested that only financially well-off consumers would be able to afford the out-of-pocket costs associated with HSAs.

Interestingly, the critics are being proven wrong. Data from insurers about the people choosing to purchase HSAs during the first two years of their availability defy their predictions. Contrary to the contention that HSAs would only be purchased by the young and the wealthy, HSAs are being purchased by individuals with varying backgrounds – both wealthy individuals and those with lower incomes are benefiting, as are young individuals and those over the age of 40. Over 3 million individuals are now enrolled in high-deductible plans with HSAs. This number is more than triple the number that had enrolled by this time last year.[27]

America's Health Insurance Plans (AHIP) Data: Many Previously Uninsured

AHIP is the national trade association representing health insurance companies throughout the United States. Since the adoption of HSAs, AHIP has conducted periodic surveys of its member companies to determine the number of people covered by HSA-eligible plans. In the most recent member survey, AHIP member companies (which effectively represent the entire market) reported that nearly 3.2 million individuals are now covered by HSA-eligible plans. Overall, HSA-eligible plans account for 23 percent of all new purchases in the individual market

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deposit. (Press Release, "Assurant Health Announces Additional Enhancements to Health Savings Accounts," Assurant Health, April 5, 2005.)
[22]HealthEquity, The Complete HSA Guidebook: How to Make Health Savings Accounts Work for You, p 8-5.
[23]MMA Section 1201.
[24]*Id.*
[25]*Id.*
[26]See, for example, Democratic Policy Committee, "Health Savings Accounts: Wrong Direction for Health Care Reform," May 13, 2004, available at http://democrats.senate.gov/dpc/dpc-new.cfm?doc_name=sr-108-2-133.
[27]Press Release, "HSA Growth Accelerating Among Employers and Consumers," America's Health Insurance Plans, March 9, 2005.

(non-employer sponsored) and 11 percent of all new purchases in the small group market.[28] What is striking, however, is not simply the *number* of individuals enrolling in high-deductible plans with HSAs – the demographics of these individuals tell the bigger story.

AHIP members report that 31 percent of new, individual coverage high-deductible policies were sold to people *who were previously uninsured*. This amounts to approximately 112,324 newly covered individuals. Similarly, 33 percent of small group policies were purchased by employers that *previously offered no health care coverage to their workers*. These policies covered 69,000 previously uninsured employees and dependents.[29] Commenting on the AHIP data, Laura Clay Trueman, Executive Director of the Coalition for Affordable Health Coverage, notes, "This is not predictive modeling data created in the ivory tower of economic theory or speculation. These are the facts. Two of the groups that make up some of the biggest cohorts of the uninsured – small businesses and individuals who lack employer-sponsored health insurance – are getting coverage."[30]

Despite critics' predictions to the contrary, most purchasers were not young individuals. Over half of HSA-eligible plan purchasers in the individual market were over the age of 40.[31] This is fairly remarkable, since individuals aged 65 and older are not eligible to open HSAs. Assuming that most individuals lose coverage under family plans at about 22 years of age, the median age of an HSA-eligible individual is 43.

An additional 23 percent of new enrollees were children age 19 and under. This is important to note because most of these individuals are not old enough to purchase coverage for themselves, indicating that families with children are benefiting from the availability of HSAs – again contradicting the critics' expectations.[32] The numbers are similar in the small and large group markets, where at least 44 percent of new policies were purchased by individuals over the age of 40, and approximately one-quarter of new policies cover children under the age of 19.[33]

eHealthInsurance Data: Many Buyers Have Moderate Incomes, Were Previously Uninsured

eHealthInsurance is an online health insurance agency that sells products from a variety of large health insurers, including Aetna, BlueCross and BlueShield companies, Kaiser Permanente, and Humana.[34] Since the introduction of HSAs, eHealthInsurance has issued a series of progress reports measuring the sales of HSA-eligible plans from its website.

In its survey of sales of HSA-eligible plans sold during calendar year 2005, eHealthInsurance found that a greater percentage of purchasers had incomes under $50,000 than

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[28] "January 2006 Census Shows 3.2 Million People Covered By HSA Plans," American's Health Insurance Plans (AHIP), March 2006.
[29] *Id*.
[30] Press Release, "New Demographic Data Confirm: HSAs Help the Uninsured," Coalition for Affordable Health Coverage, March 9, 2006.
[31] AHIP.
[32] *Id*.
[33] *Id*.
[34] See www.ehealthinsurance.com.

in 2004 (44.4 percent of purchasers in 2005 compared to 39.8 percent in 2004).[35] The single largest group of purchasers included individuals and families making only slightly more than $50,000 – 20.9 percent of HSA-eligible plan purchasers had annual incomes between $50,001 and $75,000.[36]

Along with annual income, eHealthInsurance also looked at the number of purchasers who were previously uninsured. In the lowest income bracket, those earning $15,000 or less, 41.8 percent were previously uninsured.[37] In the next income bracket, $15,001 to $35,000 per year, 42.2 percent of HSA-eligible plan purchasers were previously uninsured.[38] For those earning $35,001 to $50,000, 40.1 percent of HSA-eligible plan purchasers were previously uninsured.[39]

Reported purchasers of plans offered by eHealthInsurance differ slightly in age from those reported to have purchased plans from AHIP member companies, since eHealthInsurance plans represent only a subset of all AHIP plans. Still, a full 42 percent of those purchasing HSA-eligible plans from eHealthInsurance were over 40 years of age.[40] Presumably, most of these purchasers were individuals or couples, rather than families with young children, since only 1.6 percent of covered individuals were 19 years of age or younger (although this number was up slightly from 2004, when children comprised only 1.2 percent of covered individuals).[41]

Assurant Health Data: Demographic Variety Underscored

Assurant Health, a company that specializes in individual and small group plans, reports that 37 percent of its new plan sales since 2004 have been HSA plans.[42] To date, Assurant Health has received HSA applications to cover over 250,000 people.[43]

As with other insurers, Assurant Health found that HSAs are benefiting a variety of people. A full 43 percent of Assurant Health's HSA applicants did not have prior health coverage.[44] Families with children made up 69 percent of Assurant Health's purchasers, and 62 percent of HSA-eligible plan purchasers were over the age of 40.[45]

Assurant Health indicated that 29 percent of its purchasers had family incomes less than $50,000 per year, and 20 percent had family incomes less than $40,000 per year.[46] A full 20 percent of Assurant Health's HSA purchasers had a net worth of less than $25,000 per year.[47]

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[35] "Health Savings Accounts: January 2005-December 2005," eHealthInsurance, May 2006.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] "Quick Facts: Health Savings Accounts," Assurant Health, (date, website)
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*

BlueCross BlueShield Association Data: Participation is Not Dependent Upon Health Status

The BlueCross BlueShield Association (BCBSA), an association of independent BlueCross and BlueShield plans, had similar results in a survey conducted in August 2005.

The web-based survey questioned 3,000 individuals, including those who participated in "Blues" plans and those who did not, as well as individuals enrolled in high-deductible plans and those with traditional insurance coverage.[48] Of those surveyed by BCBSA, the group with the highest percentage of HSA uptake consisted of individuals aged 45 to 54. In this age group, 37 percent of those purchasing health coverage opted for an HSA-eligible plan.[49]

The survey also revealed that most of the HSA purchasers did not consider themselves to be in excellent health – again countering critics' contentions. Nearly as many purchasers rated their health condition to be merely "fair" (10 percent) as did those who rated their health as "excellent" (12 percent).[50] A majority of respondents (46 percent) rated their health as "good" (as opposed to "very good" or "excellent").[51]

Health Savings Accounts Are Popular for a Reason

Critics might wonder at the popularity of the HSA, but others are not surprised. Newt Gingrich, former Speaker of the House and founder of the Center for Health Transformation, recently noted that "January 1, 2004, will be looked back upon as the 'big bang' in health care policy. It was on this date that health savings accounts (HSAs) became available to all Americans."[52] Gingrich and other supporters of this concept recognize that ownership and portability of HSAs are two characteristics that set this health insurance option apart from traditional insurance plans that put employers and insurance companies in charge of health care decisions – decisions that might not be in the patient's best interest. In the case of the HSA, the individual owns the account and is able to access it at any time, regardless of his employment status.

Once an HSA is established, the account remains available for the account holder's use. If an individual changes jobs, discontinues the high-deductible plan, or otherwise becomes ineligible to contribute to the HSA, the funds already deposited in the account remain available for use (tax-free) and can accumulate interest until expended (unlike FSAs, there is no "use or lose" requirement). And because the account holder does own the account, it becomes part of his estate when he dies. If the surviving spouse is the designated beneficiary of the account, the spouse will acquire the HSA for her own use; if someone other than a spouse is the designated

[48]Press Release, "Blue Cross and Blue Shield Association Consumer Survey Shows High Rate of Satisfaction with HSAs, Cites Increased Reliance on Decision-Support Tools," BlueCross BlueShield Association, September 28, 2005.
[49]BlueCross BlueShield Association presentation, "Consumer-Directed Plans in Practice: Perspectives from Consumers and the Blues," September 28, 2005.
[50]*Id*.
[51]Surveyed individuals were asked to rate their health status as "poor," "fair," " good," "very good," or "excellent."
[52]Newt Gingrich and James Frogue, "Sticker Shock Could Help with Healthcare Costs," *The Hill*, Op-Ed, March 9, 2006.

beneficiary, the HSA is treated simply as an investment account, and the proceeds of the account (after paying any final medical expenses incurred by the account holder before death) will be included as taxable income to the beneficiary.[53] And finally, what is unique about the HSA is that the account owner has very wide latitude as to when and how he spends the funds. It is not his employer's choice or his health plan's choice, but his own. As an example of the degree of flexibility it affords individuals, consider that a person can elect between such options as spending the funds on laser eye surgery or possibly saving thousands of dollars yearly toward the future cost of long-term care.

Expansion Proposals Will Allow Even More People to Own HSAs

It is important to note that the previously discussed insurers' data reveal that approximately 1 million previously uninsured individuals now have coverage as a result of the availability and affordability of HSAs. While the numbers vary slightly by insurer (based on the studies above), together they suggest that roughly one-third of all HSA purchasers were previously uninsured. And, HSAs are becoming increasingly affordable. For example, eHealthInsurance noted that, on average, consumers in 2005 paid $348 less for their HSA-eligible health insurance plans than they did in 2004 – and this is despite "four consecutive years of double-digit increases in health insurance premiums overall."[54]

With such good preliminary demographic and trend data, Congress may want to consider how it can help to expand the HSA market so that it may become an even more powerful tool in the effort to cover uninsured Americans and reduce overall health care costs. In his State of the Union address in January, President Bush presented several proposals for expanding and improving HSAs, including allowing employers to contribute more money to the accounts of chronically ill employees than they do to other employees, raising overall contributions limits, and implementing health care tax credits. One attractive proposal would allow premiums for HSA-qualified policies purchased outside of employment (that is, in the individual market) to be reimbursed as qualified medical expenses using HSA dollars.[55]

This proposal would make the marketplace more fair since most individuals insured by employer-sponsored health plans purchase their coverage on a pre-tax basis, with the premiums automatically deducted from their paychecks. In the individual market, however, health insurance premiums are paid using after-tax dollars from take-home pay. Allowing individuals to pay the premiums for their non-employer sponsored plan on a tax-free basis simply levels the playing field and makes coverage more affordable.

Senator John Ensign (R-NV), along with Majority Leader Frist and others, has introduced legislation to implement this proposal.[56] S. 2554, the *Affordability in the Individual Market Act* (AIM), would amend the tax code to include premiums for non-group HDHPs as qualified

[53]MMA Section 1201.
[54]Press Release, "Consumers Paying an Average of $348 Less This Year for HSA-eligible Health Insurance Plans Compared to 2004," eHealthInsurance, July 27, 2005.
[55]PowerPoint presentation, "The President's Health Savings Account Proposals," National Economic Council and Council of Economic Advisors, March 10, 2006.
[56]Senator Jim DeMint (R-SC) has introduced a similar bill, S. 2549.

medical expenses. The AIM Act was introduced on April 5, 2006, and is currently pending before the Senate Committee on Finance.

Conclusion

Young, healthy, and well-off individuals are benefiting from HSAs, but so are many others. Insurers' enrollment data reveal positive evidence that HSAs provide a viable means of increasing access to and lowering the cost of individuals' health care, and these trends will likely continue, especially if proposals for expansion of the accounts are implemented. HSAs also offer an additional choice to Americans about how to provide for their long-term health care needs. Americans should welcome this healthy new addition to the health care marketplace.